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Banking Reform consultation responses
Banking Reform Team
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Dear Sirs

**Response to the Tripartite Discussion Papers:
Financial Stability and Depositor Protection: further consultation (July 2008)
Financial Stability and Depositor Protection: special resolution regime (July 2008)**

Legal & General Group Plc (Legal & General) is pleased to provide a response to the above consultation papers.

We are in full support of the Government's overall objectives for the financial system - stability, competitiveness and consumer confidence. However, we are concerned that the key issues raised by the ABI and ourselves to the last consultation paper have not been reflected in the feedback statements contained within this paper. In particular, we understand the strong focus on a failing bank, but believe some of the proposals potentially impact other sectors of the financial services industry in an inappropriate and asymmetrical manner.

We remain concerned that there is insufficient understanding that FSCS is not solely a compensation scheme for depositors. This is exemplified by some of the changes proposed to FSCS that will have far-reaching implications for other financial service institutions, but that have not been included in the impact analysis.

The significant inter-twining of the depositor protection scheme with the compensation scheme for other sectors was caused by the introduction, in April this year, of the 'general retail pool'. This was done to provide capacity in the FSCS scheme in case a small or medium-sized deposit-taker failed. The proposal to allow the FSCS to borrow funds from the National Loans Fund to lend to the FSCS means that deposit-takers can now fund the failure of another deposit-taker over a period and the rationale for the general retail pool has fallen away. It is inherently unreasonable for our customers to bear the cost of risk incurred in another unconnected financial service sector when there is no longer the justification of the need to increase the capacity of the FSCS.

The recent issues with deposit-taking institutions, and the various discussion papers on financial stability and depositor protection, have exemplified the very different risks and issues associated with the activity of deposit-taking:

- The capital structure and sheer scale of leveraging capability of the deposit-taking sector is vastly different to an insurance or other financial services company; and
- The risk profile of the deposit-taking sector is also vastly different, for example the risks of:
 - reliance on wholesale funding;
 - contagion through wholesale activities, for instance a Group undertaking both retail banking and investment banking activities; and
 - lending policies (eg sub-prime lending).

It is much more likely that a non-deposit-taker will have to contribute to the 'general retail pool' if a bank or building society were to fail. Should such a failure occur, there is likely to be a substantial call on the 'general retail pool' in the year of failure; whereas for an insurance company, the claims are likely to emerge over several years with levies made over those years. Thus, it is likely that only deposit-takers will be beneficiaries of the 'general retail pool'

It is therefore essential that the forthcoming consultation paper by the FSA on the FSCS provides a robust analysis of:

- Whether there is a continuing need for the general retail pool; and
- The impact on other sectors on any proposals for changes to meet the unique needs for the protection of depositors, including the need for short-term access to liquidity.

We have provided answers to the questions in the two consultation papers in the appendices to this letter, focussing on the two key areas where Legal & General have a particular interest:

- Legal & General is likely to have a financial involvement in any material banking institution as a shareholder/debt holder on behalf of itself, as an investor and as a business partner. To ensure orderly valuations that reflect the value of assets accurately we are keen to see an orderly, timely and transparent approach to the management of such an event established and in the public domain before the event occurs; and
- Due to the cross-subsidisation between sectors in the funding and operation of the Financial Services Compensation Scheme (FSCS), changes to the depositor protection scheme may have a substantial financial impact on the non-banking sector, including Legal & General as both an insurance firm and an asset manager.

Please regard this submission as confidential.

Yours faithfully

Philippa Scott
Compliance Strategy Director

Appendix 1: Financial Stability and Depositor Protection: further consultation

List Of Questions For Consultation

Chapter 3

- 3.1) The Authorities are seeking views from respondents on the extent that contractual provisions, such as those set out above, may prevent the Authorities from taking appropriate action; and the merits of the two approaches as set out above.**

No comment.

- 3.2) Are the criteria set out, the right criteria and will they provide sufficient flexibility as payment systems evolve over time?**

No comment.

- 3.3) Is there a preferred mechanism for recognising payment systems?**

No comment.

- 3.4) Do you agree that the indicative list in paragraph 3.47 includes all the relevant payment systems which are of systemic or system-wide importance?**

Given the emergence of new trading platforms and associated settlement agents, this area needs to be carefully monitored and the list regularly reviewed.

- 3.5) Are the powers, as set out above, necessary and appropriately graduated?**

No comment.

Chapter 4

- 4.1 The Authorities would welcome views on the most appropriate ways to deal with other relevant entities in investment banking groups with the aim of helping to maintain financial stability.**

Whilst the 'the most significant legal entities in investment banks operating in the UK are not deposit-takers', the failure of one of these is likely to have significant knock-on impacts on deposit-takers, either through their wholesale activity or through their investment banking arms. It may be that the impact is wide-spread and that action in relation to the investment bank would stop systemic risk in deposit-takers. We believe, therefore, that tools such as a SRR should be available in relation to investment banks.

We would like to understand better how the proposals around groups would work, particularly where there are significant intra-group loans.

4.2) Do you agree with the role for the Authorities for the triggering and operation of the Special Resolution Regime?

The success of the SRR will be highly dependant on the appropriate timing of initiation and the preparedness of the Authority responsible for operating the SRR. We believe that there needs to be early discussions between the Treasury, FSA and Bank of England and the FSA should have a clear obligation to trigger these discussions at an early stage, which is likely to be well before a firm fails to meet, or is likely to imminently fail to meet, its Threshold Conditions.

4.3) Respondents views are sought on the practical considerations involved in developing a SRR.

No comment.

4.4) What would be the best way to calculate the hypothetical net cost of depositor compensation payments, including the estimation of the recovery rate?

We strongly disagree with any proposals for the FSCS to pay for, or contribute towards, a SRR. The whole purpose of the FSCS is to protect depositors when an institution has failed. It is entirely inappropriate to blur the boundaries between the role of an SRR and the FSCS in this way.

Additionally, we believe that it will be impossible to determine what the costs to the FSCS would or wouldn't have been through actions taken within the SRR. Trying to calculate the hypothetical net cost of depositor protection compensations payments is fraught with difficulties and would rely on speculative assumptions. This is bound to lead to significant disputes. And, given the likely costs involved, potential judicial challenge.

The costs should be borne by the firm subject to the SRR, and either the SRR will be fully successful, or there will need to be a call against FSCS. In the case where partial transfers are made, or where a company within a larger group is subject to an SRR, the decision to undertake this action should have consideration of the costs involved and these should be charged to the residual firm and/or parent company.

It is important that those operating the SRR have accountability for the costs involved and this is best achieved if the firm subject to the SRR, or its parent company, meets the costs of the SRR.

This is an example of where the inter-twinning of the depositor protection scheme with the compensation for other types of financial service companies will cause additional risk to non-deposit-takers.

Chapter 5

The proposals in this chapter provide numerous examples of where the requirements under the FSCS will start to become starkly different for deposit-takers and non-deposit-takers and where the inter-twinning of the schemes through the general retail pool looks increasingly unsupportable and clearly unacceptable. A completely integrated compensation scheme across the

sectors regulated by the FSA will no longer be tenable and it is essential that this is recognised in the forthcoming consultation paper by the FSA on the FSCS.

5.1) The Authorities would welcome views on the best way of introducing gross payout when there are mutual debts.

No comment.

5.2) The Authorities would welcome further views on a possible move to pre-funding and on the proposed legal framework for pre-funding and FSCS borrowing from the National Loans Fund.

We remain strongly against pre-funding and have seen no evidence that there is any necessity in relation to insurance business or other financial service sectors. The pattern of claims against the FSCS in respect of insurance companies means that 'pay as you go' funding is a robust and resilient approach and ensures efficient use of capital. It would be highly unfair for the insurance industry to have to start pre-funding the FSCS simply to provide protection against the failure of deposit-taking institutions. If there is deemed to be a need for pre-funding to meet the potential failure of a deposit-taker, then this should be limited to the banking sector.

This is another example of where the inter-twinning of the depositor protection scheme with the compensation for other types of financial service companies will cause significant additional cost and risk to non-deposit-takers and we can see no basis of justification for it.

Impact Assessment

A.1) Do you have information that would improve this impact assessment?

The impact assessment in relation to borrowing from government does not seem to take account of the consequent impact on FSCS levy-payers and insurance policyholders.

Under the current FSCS scheme, there is a maximum annual levy and, as noted in the FSA's consultation paper 07/5 on the FSCS:

'While our proposals will substantially deepen the financial capacity of the scheme, it is still possible to conceive of a default (or a combination of defaults) so big as to be beyond the scheme's ability to pay compensation. Our proposals significantly reduce the probability of this happening, but they cannot eliminate it. At this point, discussions would need to be held with HM Treasury and the Bank of England via the mechanism of the Tripartite Standing Committee.'

This consultation paper states that in the event that the FSCS borrows from the National Loans Fund, the Government would become a creditor of the FSCS and that:

'These loans would have to be repaid with interest (charged at the appropriate market rates) out of future levies on the industry'.

Thus in the event of a medium-sized depositor failing, the industry would face a full annual levy of £4bn for possibly five or more years. In addition, the failure of any other financial companies during this period would lead to further loans that the industry would have to repay. So whilst the annual levy cap has not changed, the size of the potential liability to industry has increased and has no limit. The cost of this to the industry has not been taken into account in the impact assessment.

To put this into context, the anticipated call on industry in relation to claims in the financial year 08/08 is under £31m, compared to a potential annual levy of £4bn.

Additionally, due to the inter-twinning of the depositor protection scheme with the compensation for other types of financial service companies, the impact of this proposal will cause enormous additional risk to non-deposit-takers. As mentioned above, the impact on insurers of this proposal will be disproportionate as it is much more likely that a non-deposit-taker will have to contribute to the 'general retail pool' - if a bank or building society were to fail, there is likely to be a substantial call on the 'general retail pool' in the year of failure; whereas for an insurance company, the claims are likely to emerge over several years with levies made over those years. Thus, it is likely that only deposit-takers will be beneficiaries of the 'general retail pool', but insurers will contribute to the failure of deposit-takers over many years.

A.2) Do you think there are any significant indirect costs associated with this proposal?

As it stands, the inter-twinning of the FSCS arrangements are likely to lead other sectors to consider the need to challenge the legitimacy of some of the proposed changes given their unjustifiable impact on their shareholders and customers. The costs to the firms and the Authorities of these challenges would be considerable.

Appendix 2: Financial Stability and Depositor Protection: special resolution regime

List Of Questions For Consultation

Chapter 2

2.1) Do you agree with the SRR objectives as set out in clause 4?

In addition to those set out, we believe it is important for an objective of the SRR be to protect and enhance the stability of the financial services industry. We believe this is more explicit than the general 'financial systems' and given the widespread impact on financial services firms of an SRR and potential claim under FSCS, this needs to be a core and explicit objective.

2.2) Do you agree with the role of the FSA in determining the conditions for entering the SRR?

The success of the SRR will be highly dependant on the appropriate timing of initiation and the preparedness of the Authority responsible for operating the SRR. We believe that there needs to be early discussions between the Treasury, FSA and Bank of England and the FSA should have a clear obligation to trigger these discussions at such an early stage, which is likely to be well before a firm fails to meet, or is likely to imminently fail to meet, its Threshold Conditions.

2.3) Do you agree with the conditions for entering the SRR as set out in draft clause 7?

Yes.

2.4) Do you agree with the role of the Bank of England in operating the SRR in the public interest as set out in draft clause 8?

Yes, subject to the additional objective mentioned in 2.1 above.

2.5) Do you agree with the roles of the Treasury as set out in draft clauses 8(4), 8(5), 9 and 10?

Yes.

2.6) Do you agree that the SRR objectives should be supplemented by a code of practice?

Yes.

2.7) Do you agree with the proposed areas to be covered in code of practice?

As an initial approach, yes.

However this requires more consideration before the list is finalised.

Chapter 3

3.1) What are your views on the breadth of the property transfer powers in clauses 14 to 23? Are there particular powers that are lacking?

No comment.

3.2) What are your views on the nature of these powers?

No comment.

3.3) Do you consider that a company limited by shares, with the Bank of England as the sole or controlling shareholder, would be the most appropriate governance structure?

It is certainly an appropriate structure.

3.4) Do you agree that the lifespan of a bridge bank should be limited? What do you think is an appropriate length of time?

Yes, we believe that there should be a time limit for a bridge bank as the uncertainty surrounding claims on FSCS will create substantial issues for other financial services companies. We believe that a period of 6 months is sufficient.

3.5) Do you think that the extension of a bridge bank's lifetime should be subject to certain conditions? If so, what?

Yes. There should be a high degree of certainty that the extension will reduce the cost to the public finances **and** the FSCS levy payers.

3.6) Do you think that partial transfers increase the chances of the successful operation and sale of a bridge bank and the chances of a private sector purchase?

In certain circumstances, this may be the case.

3.7) Do you agree that guidelines, setting out when partial transfers might be used, should be provided in the code of practice?

Yes.

3.8) Would these guidelines provide reassurances about how the Authorities might use partial transfers?

If the governance arrangements included independent assurance and also a number of defined tests – to include that the FSCS levy-holders would not be disadvantaged from the sale.

3.9) Do you agree with the situations in which it is proposed that the partial transfer powers could be exercised?

There may be occasions where the sale of part of the Bank would remedy the issue causing stability issues – this may not be 'sanitising the balance sheet' but may include selling a strong part of the balance sheet to raise significant liquidity for instance.

3.10) What is the appropriate level of flexibility for the situations in which these powers can be used?

Inevitably, flexibility will be required. The key is to ensure that there are robust governance arrangements and transparency.

3.11) Do you think the Bank of England should have the flexibility to make subsequent transfers between a bridge bank and a residual company?

Yes, subject to the comments above.

3.12) Do you think the Bank of England should have the power to make subsequent transfers using the stabilisation powers?

In principle yes but this needs more detailed consideration.

3.13) Do you agree with the restrictions the Authorities propose for subsequent transfers (that they should only occur between a bridge bank and a residual company and not involve moving liabilities from the bridge bank to the residual company)? Should there be additional restrictions?

Theoretically the proposals should be sufficient but it may be prudent to leave the option of other approaches should they be needed over time (and different scenarios).

3.14) Do you think that the bank resolution fund is an appropriate means for compensating creditors left in the residual company?

No comment.

3.15) Do you agree that an explicit safeguard to protect set-off and netting arrangements is required?

Yes.

3.16) Do you agree with the risks of adopting a complete master netting arrangement safeguard?

There will be a risk of a master netting arrangement being abused, but as identified under paragraph 3.74, it will be difficult to draw the safeguards in such a way to enable effective commercial innovation without risking abuse of the safeguards. Additionally, as identified under paragraph 3.75, the due diligence of the safeguard approach will be challenging and may affect the speed of implementation of the partial transfer. The approach to drawing up the list of qualifying transactions will therefore need to be robust and regularly reviewed.

3.17) Should the qualifying financial contracts approach be adopted, what do you think should be defined as qualifying financial contracts?

This should be the subject of detailed consultation.

3.18) Can you suggest any alternative options for how the safeguard might be framed in a sufficiently wide but workable way?

No suggestions.

3.19) Do you agree that an explicit safeguard to protect structured finance arrangements is required?

Yes.

3.20) Do you have any workable suggestions for how the safeguard might be framed in a sufficiently wide but workable way?

No suggestions.

3.21) Do you agree that a safeguard to protect all security interests could make a partial transfer practically difficult?

Yes.

3.22) Which security interests should not be covered by this safeguard?

This safeguard should cover all security interests. Whilst a partial transfer could be difficult because of some security interests we don't believe that disregarding them simply to remove the difficulties is acceptable.

3.23) Do you consider that where part of a failing bank's business is transferred to a bridge bank, a special bank administration procedure may be required to deal with the residual company?

Yes. We agree with the SRR objectives and the special administration procedure proposed in relation to the residual company. However, this is subject to the comments in 3.24 – 3.49 below in relation to the actual procedures and safeguards for creditors and third parties.

3.24) Do you think that this special bank administration procedure should be confined to the residual company where a partial transfer is effected to a bridge bank or should it also apply, with any necessary modifications, where a partial transfer is effected to a private sector institution?

We believe it should also apply where there is a partial transfer to a private sector institution.

3.25) Do you agree that the special bank administration procedure should have specific objectives?

Yes.

3.26) Do you agree with the objectives and their priorities as proposed above? In particular, do you agree that the objective of supporting the bridge bank should take priority?

Yes. We agree that the priority objective should be the support of the residual bank to the bridge bank. However, we are concerned that the objective of supporting the bridge bank (including where appropriate a restriction on creditors rights) may in some cases be in direct conflict with the secondary priority of having "appropriate safeguards to protect

creditors” and would welcome further clarification on how these priorities might work together.

3.27) Should the grounds for commencing or applying for special bank administration be linked to the partial transfer of assets and liabilities to a bridge bank?

Yes.

3.28) Should any other grounds be included in the legislation?

No Comment.

3.29) Should the special bank administration procedure be commenced by an order of the court or initiated automatically by the direct appointment of a special bank administrator by the Bank of England?

We believe that the most appropriate procedure would be for the court to issue an order to initiate. Although we recognise that this may not be as expedient, it does provide independence from Bank of England who would play an integral part in any procedure.

3.30) Should the special bank administrator be an officer of the court, or in the interest of promoting the objectives of the SRR should he or she be subject to overall direction by the Bank of England, with the court ruling on any disputes arising in the resolution?

In line with our comment above we would prefer the Special Bank Administrator to be an officer of the court.

3.31) Are the moratorium provisions outlined above sufficient for the purposes of a special bank administration procedure? If not, what additional measures would be required?

Yes.

3.32) Do you think that the existing powers of an administrator would be sufficient for the purposes of special bank administration?

Yes. However, we disagree with the suggestion in 3.109 which suggests restricting the administrator from taking certain actions.

3.33) Should the special bank administrator be given any additional powers, including some or all of the powers of a liquidator outlined above? If so, what extra powers do you consider would be appropriate?

Yes. See comments above at 3.32

3.34) Do you agree that the Bank of England should have a key role to play in the special bank administration procedure to facilitate the successful resolution of a bridge bank and to assist in the winding up of the residual company in the interests of its creditors generally?

Whilst we believe it is necessary for the Bank of England to have a role in the process, we would not wish such a role to fetter the discretion of the appointed administrator.

3.35) Should the Bank of England rather than an initial meeting of creditors be responsible for considering and agreeing to, with or without modification, the special bank administrator's proposals?

No. Whilst we acknowledge the reason behind this in order to expedite the process, we feel this removes some of the protection afforded to creditors. We would welcome an alternative regime which included some degree of input from creditors.

3.36) Should the Bank of England rather than creditors fulfil the functions of a creditors' committee?

No. We feel that the role of the creditor committee should be there to be fulfilled by creditors to ensure creditor interests are protected. Protection of creditor interests may be difficult for the Bank of England to do given its involvement in the overall process.

3.37) Should the rights of creditors to challenge the conduct of the procedure be subject to restrictions to ensure that the principal objectives are not jeopardised?

We agree to some restrictions being necessary to obtain objectives.

3.38) Do you agree that there should not be any substantial change to the ordinary statutory order of priority of creditors in the special bank administration procedure?

Yes. However, given the role that the Bank of England would play in the administration process we would be grateful if the Authorities would confirm whether the Bank of England would be entitled to take out any fees and expenses similar to those the administrator would be entitled to as a priority over creditors.

3.39) Should any special provisions relating to statutory set-off be introduced within a special bank administration procedure?

No comment.

3.40) Do you agree that the procedure should only be terminated where the Bank of England provides consent?

Yes.

3.41) Do you think that provisions should be made for a variety of ways to bring the procedure to a close, including conversion to ordinary insolvency procedures?

Yes.

3.42) Do you agree that temporary public ownership should be subject to similar public interest tests as the Banking (Special Provisions) Act 2008?

Yes.

- 3.43) Do you agree that the Authorities should have the power to put in place a bank resolution fund for a bridge bank and temporary public sector ownership?**

Yes.

- 3.44) Do you agree that the bank resolution fund should be mandatory in the case of the bridge bank tool, but optional in the case of temporary public ownership?**

Yes, this is a practical approach.

- 3.45) Do you agree that the bank resolution fund should comprise only the net proceeds of resolution (that is, less the costs of resolution)?**

Yes.

- 3.46) Do you agree with the mechanisms for compensation and appointing an independent valuer in the circumstances set out above?**

Yes.

- 3.47) Do you agree with the proposals to confer specific powers on an independent valuer, and the nature of the powers described above and provided for in draft clause 28?**

Yes.

- 3.48) Do you agree with the principles of valuation set out in draft clause 30?**

No. We believe that the independent valuer should be allowed to value the compensation payable without imposing the assumptions stated in draft clause 30 (4).

- 3.49) Do you agree that the Treasury should have power to provide for the reconsideration of the independent valuer's determination and appeals from the valuer to a court or tribunal?**

The right to appeal should also be available for parties affected by the valuation.

- 3.49) Do you agree that alternative compensation arrangements are needed for a private sector purchaser tool that would not involve an independent valuer?**

Yes.

- 3.50) Should any of the costs described above not be covered by the FSCS, under the Authorities proposals? Please explain why.**

We strongly disagree with any proposals for the FSCS to pay for, or contribute towards, a SRR. The whole purpose of the FSCS is to protect depositors when an institution has failed. It is entirely inappropriate to blur the boundaries between the role of an SRR and the FSCS in this way.

We believe that it will be impossible to determine what the costs to the FSCS would or wouldn't have been through actions taken within the SRR. Trying to calculate the hypothetical net cost of depositor protection compensations payments is fraught with difficulties and would rely on speculative assumptions. This is bound to lead to significant disputes. And, given the likely costs involved, potential judicial challenge.

The costs should be borne by the firm subject to the SRR, and either the SRR will be fully successful, or there will need to be a call against FSCS. In the case where partial transfers are made, or where a company within a larger group is subject to an SRR, the decision to undertake this action should have consideration of the costs involved and these should be charged to the residual firm and/or parent company.

It is important that those operating the SRR have accountability for the costs involved and this is best achieved if the firm subject to the SRR, or its parent company, meets the costs of the SRR.

This is an example of where the inter-twinning of the depositor protection scheme with the compensation for other types of financial service companies will cause additional risk to non-deposit-takers.

3.51) Are there any additional costs of resolution which could be borne by the FSCS?

No.

Chapter 4

4.1) Do you agree with the provisions for entry into the bank insolvency procedure, as set out in draft clauses 38-41, 60 and 62?

Yes.

4.2) Do you agree with the provisions for the appointment and objectives of the bank liquidator, as set out in draft clauses 37, 42, 46 and 47?

Yes, except in section 47(3), after relevant account, add 'subject to the appropriate FSCS limits'.

4.3) Do you agree with the provisions for the powers and responsibilities of the bank liquidator, as set out in draft clauses 47, 48, 61, 63 and 66?

Yes.

4.4) Do you agree with the provisions for the liquidation committee, as set out in draft clauses 44 and 45?

We believe it would be appropriate for there to be an independent member of the liquidation committee, to ensure that the interests of other creditors are adequately addressed.

4.5) Do you agree with the provisions for the end of the bank insolvency procedure, as set out in draft clauses 50-58?

Yes.

Chapter 5

5.1) Do you agree that the objectives, roles of the Authorities and governance of the SRR should not differ for building societies and banks?

Yes.

5.2) Do you agree that the Authorities should have powers to disapply statutory requirements including the principal purpose and lending and funding limits, for the residual element of a building society following a partial transfer?

Yes.

5.3) Do you agree that there should be a special building society administration procedure for building societies in the event that part of a building society's business is transferred to a bridge bank?

Yes.

5.4) Would temporary public ownership be a useful tool for resolving a failing building society in some circumstances?

Yes.

5.5) How would this tool best be implemented in the case of a building society, given the lack of applicability of the share transfer power?

No comment.

5.6) Should a set of principles be established to determine how compensation is distributed between members of building societies? If so, what would be the most appropriate fair and equitable principles?

No comment.

5.7) What are the risks in creating a pre-determined set of principles for distributing compensation?

No comment.

5.8) Should the former members have a say in how compensation is distributed?

No comment.

5.9) Do you agree that the Government should legislate to enable the Treasury to create, alter or nullify contracts between group companies, and introduce duties for group companies (where necessary) to cooperate with the use of these powers?

Yes.